STUDY GROUP ON MARKET MECHANISMS IN FEDERAL STUDENT LOAN PROGRAMS

POSSIBLE MODELS FOR CONSIDERATION

Introduction

Setting lender yield on FFELP Stafford, PLUS, and Consolidation loans has been and continues to be the subject of controversy. Best models to consider depend to some extent on the policy goal or goals to be achieved. Apparent policy goals are: (1) to keep borrower interest as low as reasonably possible as one factor in keeping postsecondary education opportunity available for all citizens; and (2) to provide a lender yield sufficient, along with other program features such as insurance, to maintain lender commitment to make the loans universally available. The first goal has been facilitated by setting borrower interest rates at a different, lower rate than lender returns. The second is reflected in the current provision of a special allowance for lenders in addition to the current rate paid by borrowers. The differential is specified in statute, and has been set for more than two decades by the Federal legislative process. Congress periodically has modified the provision, ultimately on a basis that would be accepted by the President (albeit with some reluctance due to preference for a different level of lender yield).

The charge for the present study is to identify at least three different "market mechanisms for use in determining lender return on student loans while continuing to meet the other objectives of the programs under parts B and D" of Title IV of the Higher Education Act "including the provision of loans to all eligible students." Consideration is to be given to the use of auctions, but there is no apparent limitation on the number of models to be evaluated or on provision of reasonable alternative models, and there is room for some flexibility in interpretation of the term "market mechanisms." The evaluation report to Congress is to evaluate each identified model on a lengthy list of factors.

Probable Consequences of Using Auctions as the "Market Mechanism"

A prime policy objective largely achieved in recent years has been to foster concentration of all of a borrower's FFELP loans with a single holder/servicer in the repayment period. The reason for this is to minimize borrower confusion regarding the borrower's loan debt and simplify the repayment process for the borrowers. This is a desirable service to borrowers and helps to cut down risks of avoidable defaults. A straight auction of the right to originate FFELP loans likely would seriously compromise the ability to continue to achieve that objective, at least without very complex rules and relationships. Transition to such a model almost certainly would create significant initial disruptions in universal, convenient availability of the loans and lead to concentration in a greatly reduced number of lenders.

An alternative in which the Federal government directly originated the loans and then sold them off on a competitive basis, either directly or in securitized lots, would create similar issues requiring complex bureaucratic measures to avoid splitting student loans for individual borrowers still in school. It also would represent a total reworking of the sources of capital. And it would eliminate the competitive incentives originators and holders of the loans presently have to provide both best possible services and cost advantages to borrowers from origination through payoff and best possible services to schools.

It is therefore important to identify and evaluate a range of alternative models that might accomplish the implied objective of the mandated study: to provide a mechanism for setting lender return which will provide a level of lender yield on FFELP loans which meets *but does not exceed* the level required, along with other program features such as insurance, to maintain lender commitment to make the loans universally available.

Precise achievement of the exact level, below which eligible organizations (lenders *and* secondary markets) would not make the loans, might just barely keep the loans available. It would, however, lead to serious compromise (upward) of net costs for many borrowers and (downward) of the quality of service provided in making and servicing the loans. Some margin above that exact level probably is highly advisable although not easy to deduce or calculate precisely. In setting this margin, it is important that there be sufficient incentives to motivate provision of high quality and responsive services to meet the needs of students, families *and schools.* The twin goals of maximum afford-ability *and* quality services are both essential in providing needed opportunity for postsecondary access.

Some Possible Models as Alternatives to Auctions

1. Incremental Adjustments Model. This model would involve an acknowledged tactic of making periodic small downward adjustments in the rates of lender yields while carefully monitoring any apparent changes after each such incremental adjustment, in: (1) lender participation in making the loans; and (2) continued investments to maintain or improve quality of services for schools and borrowers. Part of this model would need to be action to stop further downward adjustments as soon as such changes in lender participation reach a point of alarm or concern. Once an acceptable "equilibrium point" is reached or exceeded, one final modest upward adjustment might be needed to stabilize the lender participation situation. It should be noted that administration of this model would not necessarily be automatic. Value judgements about what constitutes a desired level of lender participation could vary. Would it matter, for example, if only a handful of very large national institutions were to decide or be able to participate? And of course this model–which essentially is what has been taking place in recent years--carries the danger of creating significant availability and service disruptions during the period before a damage-causing yield reduction could be rectified . If this model were to be retained, it would be desirable to have it administered in an even-handed manner, possibly by delegation to a "blue ribbon commission." (See #3, below.)

2. Cost of Funds Model. This model would involve development and careful analysis of information about the cost of funds lenders use to finance the origination and carrying of the student loans, together with normative information on a reasonable range of servicing costs associated with an acceptable level of effectiveness and borrower customer services. Based on these two sets of information an appropriate and reasonable differential between cost of funds and cost of servicing can be determined and used to determine a market-based lender yield rate for each category of loan. This model would require annual development of the two sets of information and adjustment of the lender yield from time to time if a need to do so were indicated by the data. This approach might be broadly similar to the public utility commission approaches for regulated utilities, except that the complexity and extent of data gathering would not need to be nearly as great. In addition to the value judgement on the nature of desired lender participation, another value judgement would be whether to try to differentiate between the lender/holder costs of servicing for loans for different types of students or students who attend different types of schools, or of student loan accounts of different sizes. A preferred judgement on that issue would seem to be to apply the model at a macro level with sufficient flexibility for lenders to meet the needs of students attending all types of eligible schools, backstopped with lender of last resort provisions such as presently are provided. This model, also, might be most even-handedly administered through a blue ribbon commission as described in #3. (In fact, the type of data described here are those the blue ribbon commission would need to consider in any event.)

3. Blue Ribbon Commission Model. The information and analytical tools needed to evaluate operating margins necessary for lenders to effectively and efficiently continue to provide the loans to borrowers are available. A case can be made that very sound information on this issue was provided by a number of economists and underwriting firms as well as others in the extensive debate and analysis leading to the recent Congressional compromise in setting the lender yield provisions currently in effect. Unfortunately, much of the analysis was provided by sources which major political opponents would not accept as objective because of direct or indirect vested interests. And significantly different interpretations, both of what the relevant data were and what the data meant, were presented by the Administration and Congressional agencies.

Much has been said about problems with having the yield determinations made through the legislative policy process, including contentions that undue political influence by one side or the other has led to flawed determinations, and contentions that the process too frequently wastes too much of the Congress's time and effort. Because of the need to consider public policy goals in addition to pure business or efficiency goals, there is good reason to keep the determination broadly subject to the legislative process.

However, a workable alternative to frequent legislative resetting of the lender yields can be patterned after the occasions on which politically difficult and contentious decisions on complex issues have been handled with some success by a "blue ribbon commission," Not the least of the examples are Social Security preservation and base closing decisions.

In this model, a commission would be established, composed of persons whose stature and reputation, independence of mind and decision-making capability are high and unquestioned. The composition of the commission would need to be balanced between political parties and various segments of society with some interest in the outcome of the decisions to be made, including current and/or former members of Congress and the Executive Branch.

The commission would need to be provided a very small but highly qualified professional staff to assist it in sifting, organizing, and evaluating the statistical information readily available from a variety of sources including (but not limited to) Executive departments, GAO and CBO. The commission would be empowered to determine necessary lender yields to meet parameters such as those discussed above, annually in advance of the development of the Federal Budget.

Combinations of the Models. The first two described models *could* be implemented without creating such a blue ribbon commission, using a combination of Congressional Committee staff work, prescribed data analyses provided by CBO and Executive Departments, and committee hearings, culminating in occasional amendments to program statutes. Or the blue ribbon commission could be established and charged to make independent determinations on the lender yields annually in advance of the development of the Federal Budget using either or both of the methods involved in the other two models. A variation possible on any of the models could be some differentiation of analysis, and possibly of determined yields, for two or more different groupings of lenders. This is pointed out here, *not as a recommendation,* but only because a supposition has been expressed in Study Group discussions that such differentiation might need to be considered. The Study Group needs to consider *very carefully* the pros and cons of any attempt at such a differentiation.

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